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C O N F I D E N T I A L SECTION 01 OF 07 LONDON 15193

DEPARTMENT PASS TREASURY FOR DON SYVRUD FROM JIM AMMERMAN

E.O. 11652: GDS

TAGS: EFIN, UK

SUBJECT: ECONOMIC ASSESSMENT AND SHORT-TERM FORECAST
OF THE U.K. THROUGH 1976

REF: AMMERMAN/SYVRUD TELCON

SUMMARY: 1975 HAS RECORDED DECLINES IN GROSS DOMESTIC
PRODUCT, MANUFACTURING PRODUCTION AND MANUFACTURING IN-
VESTMENT. PRICES AND UNEMPLOYMENT INCREASED SHARPLY.
LARGELY BECAUSE OF WEAK DOMESTIC DEMAND, THE BALANCE OF
PAYMENTS HAS SHOWN IMPROVEMENT. THE GOVERNMENT ADOPTED
AN INCOMES POLICY AND THERE ARE SIGNS THAT THE TRADE UNI-
ONS ARE GIVING IT BEGRUDGING ACCEPTANCE. 1976 WILL SEE
SOME UPTURN IN GROSS DOMESTIC PRODUCT AND MANUFACTURING
PROOUCTION. THERE WILL BE CONTINUING DECLINE IN INVEST-
MENT IN MANUFACTURING. THE RATE OF INFLATION WILLBE CUT
SHARPLY (IN UK TERMS) BUT TOWARDS THE END OF 1976 IT WILL
STILL BE ONE OF THE HIGHEST IN ANY MAJOR INDUSTRIALIZED
COUNTRY. UNEMPLOYMENT WILL CONTINUE TO RISE DURING
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1976. NO APPRECIABLE ADDITIONAL IMPROVEMENT IS FORESEEN

IN THE BALANCE OF PAYMENTS. STERLING'S TRADE WEIGHTED DEPRECIATION WILL CONTINUE TO WIDEN THROUGH 1976. THE UK HOPES TO LINK ITS ECONOMIC RECOVERY TO INCREASED EXPORTS RESULTING FROM THE UPTURN IN WORLD TRADE. MAJOR REFLATIONARY MEASURES WILL BE RESISTED FOR AS LONG AS POSSIBLE, I.E., UNLESS THE RISING LEVEL OF UNEMPLOYMENT IS JUDGED TO BE POLITICALLY UNACCEPTABLE. THE GOVERNMENT WILL DO ITS BEST TO CUT PUBLIC SECTOR BORROWING NEXT YEAR TO FREE RESOURCES FOR INVESTMENT. MAJOR EFFORTS WILL BE MADE TO PROMOTE MANUFACTURING INVESTMENT AND PRODUCTIVITY, AND TO ASSIST THOSE COMPANIES AND INDUSTRIES WHICH ARE JUDGED TO BE MOST VIABLE IN INTERNATIONAL COMPETITION, BUT THE RESULTS WILL NOT BE SEEN NEXT YEAR. END SUMMARY.

DIAGNOSIS OF THE PRESENT SITUATION

1. THERE IS GENERAL AGREEMENT THAT THE MAJOR SHORT-TERM PROBLEM FACING THE UK IS THE NEED TO BREAK THE BACK OF WAGE GENERATED INFLATION WHICH UNDERLIES THE SHARP INCREASE IN THE RETAIL AND WHOLESALE PRICE INDEXES. CHANCELLOR HEALEY'S OWN ANALYSIS, PUBLICLY STATED, IS THAT EXCESSIVE WAGE BILLS HAVE FORCED BUSINESS TO LAY OFF WORKERS AND HAVE DIVERTED RESOURCES WHICH SHOULD HAVE GONE INTO INVESTMENT TO CREATE MORE JOBS. SOARING PRICES COMBINED WITH THE FEAR OF UNEMPLOYMENT HAVE MADE PEOPLE SPEND LESS AND SAVE MORE, REDUCING DEMAND AND EMPLOYMENT STILL FURTHER. A FURTHER DANGER IS THAT AS THE PRICE OF PRODUCTS GOES UP, THE UK EXPORTS LESS AND IMPORTS MORE. STILL MORE JOBS ARE LOST. AS THE VALUE OF THE POUND GOES DOWN IN CONSEQUENCE, INFLATION IS GIVEN A FURTHER BOOST. SO THE VICIOUS CIRCLE GOES ON.

2. THE COUNTRY IS IN RECESSION. OUTPUT IS FALLING AND UNEMPLOYMENT RISING. THE CHANCELLOR'S STRATEGY AIMS AT PROMOTING LONG-TERM EXPANSION OF THE ECONOMY THROUGH GROWTH OF EXPORTS AND INVESTMENT. HE PLANS TO CONCENTRATE GOVERNMENT ASSISTANCE TO INVESTMENT IN COMPANIES AND INDUSTRIES WHICH HAVE THE GREATEST CHANCE OF BEING VIABLE IN INTERNATIONAL COMPETITION. DESPITE A HIGH AND GROWING RATE OF UNEMPLOYMENT, THE GOVERNMENT WILL HOLD

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OFF AS LONG AS POLITICALLY POSSIBLE FROM ANY FORM OF CLASSIC REFLATION, ALTHOUGH SOME MEASURES, IN PART COSMETIC, HAVE BEEN TAKEN TO PRESERVE JOBS OR CREATE EMPLOYMENT. THE HOPE IS THAT BY HOLDING DOWN DOMESTIC CONSUMPTION, THE UK WILL BE IN A POSITION TO IMPROVE ITS BALANCE OF PAYMENTS AND STIMULATE THE ECONOMY THROUGH THE GROWTH OF EXPORTS IN THE HOPED-FOR WORLD ECONOMIC UPTURN COMING LATER THIS YEAR AND IN 1976. THIS IS A VIABLE STRATEGY,

BUT THERE IS SOME CONCERN THAT BRITISH INDUSTRIAL PLANT IS OR WILL BE INADEQUATE TO EXPLOIT FULLY THE OPPORTUNITIES THAT WILL OFFER THEMSELVES. SOME BENEFIT TO THE BALANCE OF PAYMENTS CAN BE EXPECTED FROM NORTH SEA OIL IN 1976, AND EVEN WITH DELAYS, IT SHOULD BEGIN TO MAKE A SIGNIFICANT CONTRIBUTION IN FOLLOWING YEARS.

3. LOOKING AHEAD, THE CHANCELLOR SEES TWO MAJOR MEDIUM

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TERM GOALS. ONE IS TO PROMOTE MANUFACTURING INVESTMENT AND MAKE BETTER USE OF EXISTING CAPITAL EQUIPMENT. THE OTHER IS REDUCING THE LEVEL OF THE GOVERNMENT'S BORROWING REQUIREMENT, CUTTING PUBLIC EXPENDITURE IN REAL TERMS.

4. THE CHANCELLOR'S DIAGNOSIS IS GENERALLY SHARED BY INDUSTRY AND THE TRADE UNIONS, WITH SOME NOTABLE EXCEPTIONS IN THE LEFT WING OF THE LABOUR PARTY AND THE UNIONS. AN ADDITIONAL PSYCHOLOGICAL FACTOR IS THE LOW LEVEL OF BUSINESS CONFIDENCE. IN PART, THIS IS ENGENDERED FROM THE

CURRENT ECONOMIC SITUATION BUT IT ALSO REFLECTS AN ANTI-PATHY ON THE PART OF MANY BUSINESSMEN WHICH RUNS FROM SKEPTICISM TO OUTRIGHT HOSTILITY TOWARDS THE LABOUR PARTY'S GOALS. THE SHIFT OF WEDGWOOD BENN FROM THE DEPARTMENT OF INDUSTRY TO THE DEPARTMENT OF ENERGY HAS IMPROVED THE CLIMATE SOMEWHAT, BUT UK AND FOREIGN BUSINESS MEN, INCLUDING US OIL COMPANIES OPERATING IN THE NORTH SEA REMAIN DISTRUSTFUL OF THE LABOUR PARTY'S LONG TERM GOALS AND ARE FEARFUL OF THE CONSEQUENCES SHOULD THE LEFT WING OF THE LABOUR PARTY GAIN DOMINANCE.

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5. EQUALLY MISSING IN THE LABOUR PARTY'S OWN DIAGNOSIS OF THE CURRENT SITUATION IS AN ADEQUATE APPRECIATION OF THE ROLE OF PROFITS, INCENTIVES, AND INFLATION ACCOUNTING. THE PERCENTAGE SHARE OF GROSS TRADING PROFITS OF INDUSTRIAL AND COMMERCIAL COMPANIES IN GROSS DOMESTIC INCOME (GDI) HAS FALLEN OVER THE LAST FIFTEEN YEARS. THIS IS TRUE WHETHER THE CALCULATION IS DONE BEFORE OR AFTER DEDUCTING INVENTORY APPRECIATION. THE LATTER IS MORE STRIKING; BANK OF ENGLAND (BOE) COMPUTATIONS SHOW A DECLINE IN THE SHARE OF PROFIT IN GDI FROM 17 PERCENT IN 1960 TO 11 PERCENT IN 1970 TO 8.5 PERCENT IN 1974. BOE ESTIMATES THAT RETURN ON INVESTMENT IN THESE COMPANIES FELL FROM 12.5 PERCENT IN 1960 TO 6 PERCENT IN 1970 TO 3 PERCENT IN 1974. INFLATION, THE FAILURE TO ADEQUATELY ACCOUNT FOR IT IN BALANCE SHEETS, AND POOR PRICING POLICIES RESULTED IN INVENTORY APPRECIATION AS A PERCENTAGE OF GROSS TRADING PROFITS INCREASING FROM 6 PERCENT IN 1960 TO 17.5 PERCENT IN 1970, TO 27 PERCENT IN 1973 AND 47 PERCENT IN 1974. UNTIL RELIEF WAS PROVIDED IN THE 1974 BUDGET THESE PAPER PROFITS WERE FULLY TAXED.

6. WE CAN ONLY SPECULATE ON THE DEBILITATING EFFECT THAT HIGH RATE OF PERSONAL TAXATION COUPLED WITH THE CAPITAL TRANSFER TAX AND THE PROPOSED WEALTH TAX WILL HAVE ON INCENTIVE. FOR EXAMPLE, AT 10 THOUSAND POUNDS TAXABLE INCOME, THE MARGINAL RATE OF PERSONAL TAXATION BECOMES 65 PERCENT; AT 12 THOUSAND POUNDS IT IS 70 PERCENT; AT 15,000 POUNDS 75 PERCENT AND OVER 20 THOUSAND POUNDS IT BECOMES 83 PERCENT. INVESTMENT INCOME (CALLED UNEARNED INCOME HERE) IS ADDED TO TAXABLE INCOME AND, IN ADDITION TO THE HIGHEST MARGINAL RATE OF THE INDIVIDUAL TAXPAPER, (ONCE AN EXEMPTION OF ROUGHLY 2,000 POUNDS IS ALLOWED AT EITHER 0 OR REDUCED RATES), INVESTMENT INCOME PAYS THE MARGINAL RATE PLUS AN ADDITIONAL 15 PERCENT CARRYING THE MAXIMUM RATE TO A CONCEIVABLE 98 PERCENT. THESE RATES ARE DESIGNED TO INSURE REDISTRIBUTION OF INCOME, AND TO ARRIVE AT WHAT THE LABOUR GOVERNMENT CALLS A FAIR SOCIETY, BUT MANY MIDDLE AND UPPER CLASS BUSINESSMEN REPORT THAT

THE EFFECT ON THEM IS TO EITHER REDUCE THE INITIATIVE TO
WORK, OR TO INDUCE KEY EXECUTIVES TO EITHER EMIGRATE OR
TAKE OVERSEAS POSITIONS OR, FRANKLY, TO CHEAT AND EVADE
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TAXATION TO THE MAXIMUM.

POLICY RESPONSES TO THE EXISTING SITUATION

7. WITH THE AIM OF REDUCING THE RATE OF INFLATION TO
SINGLE DIGITS BY THE END OF 1976, THE GOVERNMENT HAS IN-
TRODUCED AN INCOMES POLICY LIMITING SALARY AND WAGE IN-
CREASES TO A MAXIMUM OF 6 POUNDS A WEEK, WITH NO POSSI-
BILITY OF INCREASES FOR WORKERS AND EMPLOYEES EARNING
MORE THAN 8,500 POUNDS A YEAR. THE AIM IS TO HOLD DOWN
THE INCREASE IN THE NATIONAL WAGE BILL TO ROUGHLY 11 TO
12 PERCENT THROUGH JULY 1976. THUS FAR, INDICATIONS ARE
THAT THE PROGRAM WILL BE MODERATELY SUCCESSFUL. THE MAJ-
OR UNIONS SHOW BEGRUDGING ACQUIESCENCE, ALTHOUGH MOST
UNIONS TAKE THE 6 POUND FIGURE TO BE AN ENTITLEMENT IN
WAGE NEGOTIATIONS RATHER THAN A CEILING. THIS WAS THE
CASE WITH LOW PAID LOCAL GOVERNMENT MANUAL WORKERS, WHO
WERE GRANTED THE FULL SIX POUND INCREASE. THIS WILL HAVE
THE EFFECT OF PUSHING UP LOCAL RATES (PROPERTY TAXES) AND
POSSIBLY REDUCING EMPLOYMENT IN THIS SECTOR. IT IS LIKE-
LY THAT THIS EXAMPLE WILL BE CARRIED OVER INTO WAGE NE-
GOTIATIONS WITH OTHER UNIONS REPRESENTING LOWER PAID
WORKERS, BUT REPORTEDLY THIS WAS THE PRICE THAT UNION

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LEADERS EXACTED FROM THE GOVERNMENT IN RETURN FOR SUPPORT-
ING THE SIX POUND LIMIT.

8. THE REAL TEST FOR THE INCOMES PROGRAM WILL NOT COME UN-
TIL NEXT YEAR WHEN AGREEMENTS WITH MANY OF THE POWER-
FUL AND BETTER PAID UNIONS WHICH RECEIVED VERY HIGH WAGE
INCREASES IN THE SPRING OF THIS YEAR COME UP FOR RENEGO-
TIATION. MEMBERS OF THESE UNIONS WILL HAVE SEEN THEIR
REAL PURCHASING POWER DECLINE; IT WILL BE THE DEGREE OF
MODERATION OR LACK OF IT THAT THEY SHOW WHICH WILL MAKE
OR BREAK THE PROGRAM. EVEN ASSUMING A MODERATELY suc-
CESSFUL OUTCOME IT IS UNLIKELY THAT THE GOVERNMENT'S AIMS
WILL BE COMPLETELY MET. (THE TABLES IN THE FINAL SECTION
OF THIS REPORT GIVE A MORE QUANTITATIVE ANALYSIS.)

9. LOOKING INTO 1976, THE GOVERNMENT WILL ALSO NEED TO
PREPARE A SECOND MORE FLEXIBLE STAGE OF THE INCOMES
POLICY TO REPLACE THE CURRENT ONE. EVEN IF THE UK IS
MODERATELY SUCCESSFUL IN ITS AIMS, IT WILL PROBABLY BE AT
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OR NEAR THE TOP OF THE INFLATION RATE LEAGUE AMONG MAJOR
INDUSTRIALIZED COUNTRIES AT THIS TIME NEXT YEAR. THE
RATE OF INFLATION (RETAIL PRICE INDEX) CURRENTLY RUNNING
AT 26.7 PERCENT (AUGUST 1975 OVER THE PREVIOUS AUGUST)
SHOULD DECLINE TO THE 12 TO 13 PERCENT RANGE BY THE END
1976. THE SHAPE OF THIS DECLINE WILL BE INFLUENCED BY
THE PRICE INCREASES EMERGING FROM THE PIPELINE BETWEEN
NOW AND THE END OF THE YEAR. THESE INCLUDE INCREASES AS
HIGH AS 60 PERCENT FOR SOME TELEPHONE SERVICES, 30 PER-
CENT IN POSTAL CHARGES, RAIL FARES AND ELECTRICITY BILLS
AS WELL AS SUBSTANTIAL HIKES IN IMPORT COSTS AS THE POUND
SINKS LOWER. AS A RESULT, IT IS UNLIKELY THAT THE RATE
OF INCREASE IN PRICES WILL SLACKEN NOTICEABLY BEFORE THE
END OF 1975. BY THEN THE BULK OF THE INCREASES NOW IN
THE PIPELINE SHOULD HAVE BEEN WORKED OFF WITHOUT BEING

REPLACED BY POTENTIAL RISES OF THE SAME MAGNITUDE. THEREFORE THE RATE OF PRICE INCREASE SHOULD FALL OFF CONSIDERABLY FROM THE EARLY SPRING, BARRING ANY MAJOR BREACH IN THE SIX POUND INCOMES POLICY.

10. THE GOVERNMENT WILL TAKE FURTHER INITIATIVES TO PROMOTE EXPANSION OF THE ECONOMY THROUGH INVESTMENT AND IMPROVED PRODUCTIVITY. TO SOME EXTENT, IT ALREADY MADE A START IN THIS YEAR'S BUDGET AND WITH THE ADDITIONAL MEASURES ANNOUNCED LAST WEEK TO PROMOTE INVESTMENT IN NEW FACTORIES AND MODERNIZATION OF EXISTING PLANT. (SEE LONDON 14898 AND 14783.) A MAJOR NEW STEP IN THIS DIRECTION WILL BE THROUGH MEDIUM TERM INDUSTRIAL STRATEGY AIMED AT PROMOTING INVESTMENT WITH GOVERNMENT ASSISTANCE IN THOSE DOMESTIC COMPANIES AND INDUSTRIES WHICH SHOW THE GREATEST POTENTIAL FOR SUCCESS IN INTERNATIONAL COMPETITION. IN THE NEAR TERM, AND TAKING INTO ACCOUNT THE LOW LEVEL OF BUSINESS CONFIDENCE, THERE IS EVERY INDICATION THAT GROSS FIXED INVESTMENT WILL DECLINE ABOUT 10 TO 15 PERCENT THIS YEAR AND IN A SIMILAR RANGE IN 1976, THE SHARPEST DECLINE COMING IN THE SECOND HALF OF THIS YEAR AND THE FIRST HALF OF NEXT. THERE WILL BE INTERNAL PRESSURES WITHIN THE LABOUR PARTY AND TRADE UNIONS AIMED AT SUPPORTING INEFFICIENT INDUSTRIES IN ORDER TO KEEP UNEMPLOYMENT FROM RISING. THERE WILL ALSO BE CONTINUING DEMANDS FOR SELECTIVE IMPORT CONTROLS. THE GOVERNMENT THUS

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FAR HAS SUCCESSFULLY RESISTED THESE PRESSURES BUT MAY BE FORCED -- AND PERHAPS SOON -- TO GIVE GROUND BECAUSE OF INTERNAL LABOUR PARTY POLITICAL CONSIDERATIONS.

11. INDUSTRIAL PRODUCTION AND GDP HAVE BEEN FALLING SHARPLY, LARGELY AS A RESULT OF INVENTORY RUNDOWN WHICH SHOULD CEASE IN THE SECOND HALF YEAR. THE END OF INVENTORY DEPLETION AND THE UPTURN IN WORLD TRADE AND ATTENDANT UK EXPORT GROWTH ARE EXPECTED TO REVERSE EXISTING OUTPUT TRENDS LATER THIS YEAR OR EARLY NEXT. AS NOTED, THE GOVERNMENT IS UNLIKELY TO TAKE ANY MAJOR STEPS TO REFLATE UNLESS UNEMPLOYMENT CLIMBS TO POLITICALLY UNACCEPTABLE LEVELS (SAY OVER 1.5 MILLION S.A.) FOR TOO LONG A PERIOD. SHOULD THAT HAPPEN, IT WOULD FEEL FORCED TO REFLATE THROUGH CONSUMER LED MEASURES. UNEMPLOYMENT WHICH INCREASED FROM 2.8 PERCENT SEASONALLY ADJUSTED IN DECEMBER 1974 TO 4.5 PERCENT IN SEPTEMBER IS EXPECTED TO REACH A HIGH POINT OF 6 TO 7 PERCENT IN 1976, BEFORE BEGINNING TO RECEDE SLOWLY. THERE IS BOUND TO BE SOME FURTHER LABOR SHAKEOUT AND UNEMPLOYMENT WILL CONTINUE IN THE UK AT HIGHER THAN NORMALLY HISTORIC LEVELS THROUGHOUT 1976 AND 1977. THE GOVERNMENT HAS TAKEN HIGHLY PUBLICIZED STEPS

AIMED AT RETRAINING, SHIFTING EMPLOYMENT FROM DECLINING

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TO GROWING INDUSTRIES, JOB CREATION FOR RECENT GRADUATES AND SCHOOL LEAVERS. IF BY MARCH-APRIL 1976 THE INCOMES POLICY IS JUDGED TO BE REASONABLY SUCCESSFUL, THE GOVERNMENT MAY FEEL THAT IT HAS SOME SCOPE FOR LIMITED REFLATIONARY MEASURES IN A LATE MARCH OR APRIL BUDGET; A DECISION ALONG THESE LINES IS MANY MONTHS AWAY.

12. IN ORDER TO HELP FREE THE RESOURCES NECESSARY TO PROMOTE INVESTMENT AND EXPORTS, THE GOVERNMENT WILL TRY TO REDUCE THE PUBLIC SECTOR BORROWING REQUIREMENT, ORIGINALLY ESTIMATED AT 9 BILLION POUNDS IN THE CURRENT FISCAL YEAR (APRIL 75 - MARCH 76) BUT WHICH SOME OBSERVERS BELIEVE IS CURRENTLY RUNNING AT AN ANNUAL RATE OF 11 BILLION POUNDS MEASURED AGAINST CURRENT ANNUAL RATE OF GDP OF ROUGHLY 90 BILLION POUNDS. IN APPROXIMATE TERMS, THE CHANCELLOR HOPES TO CUT THE BORROWING REQUIREMENT BY ONE PERCENT OF REAL GDP IN NEXT YEAR'S BUDGET AND KEEP IT AT

THAT LEVEL FOR THE FOLLOWING TWO YEARS. PART OF THE RATIONALE IS TO FREE RESOURCES FOR THE PRIVATE SECTOR. LOCAL GOVERNMENTS HAVE ALREADY BEEN WARNED OF THE GOVERN-
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MENT'S DETERMINATION (SEE LONDON A-803). THIS WILL BE A PAINFUL TASK FOR A LABOUR GOVERNMENT AND WILL BITE DIRECTLY INTO THOSE PROGRAMS DEAREST TO THE LABOUR PARTY'S AIMS AND MANIFESTO. IT IS PROBABLE THE CHANCELLOR WILL HAVE LIMITED SUCCESS, BUT THERE ARE NO GROUNDS FOR OBJECTIVE OPTIMISM BASED ON PAST PERFORMANCE.

13. THE BANK OF ENGLAND WILL CONTINUE TO FOLLOW A TIGHT MONETARY POLICY. WITH WEAK PRIVATE DEMAND FOR CREDIT AND THROUGH LARGE SALES OF GILTS TO THE NON-BANK PRIVATE SECTOR, THE BANK HAS BEEN ABLE TO KEEP THE GROWTH OF M1 AND M3 BELOW THE LEVEL OF NOMINAL PRICE INCREASES. WHEREAS THE GOVERNMENT WOULD LIKE TO SEE A LOWER LEVEL OF STERLING INTEREST RATES TO HELP PROMOTE DOMESTIC INVESTMENT, INTERNATIONAL CONSIDERATIONS WILL KEEP STERLING INTEREST RATES AT A LEVEL COMPETITIVE WITH THE U.S. AND OTHER INTERNATIONAL MONETARY CENTERS. PHRASED DIFFERENTLY, THE LEVEL OF UK INTEREST RATES WILL BE LARGELY DETERMINED BY THE FEDERAL RESERVE BOARD RATHER THAN BY THE BANK OF ENGLAND.

14. THE CONTINUING EFFECTS OF STERLING DEVALUATION AND THE FORCES OF DEEPENING DOMESTIC RECESSION ARE HAVING A BENEFICIAL AND MEASURABLE IMPACT ON THE UK BALANCE OF PAYMENTS POSITION. WHILE THE OVERALL CURRENT ACCOUNT PERFORMANCE DURING THE SECOND HALF OF 1975 WILL NOT SHOW IMPROVEMENT TO THE DEGREE EXPERIENCED IN THE FIRST HALF, THE CURRENT ACCOUNT DEFICIT FOR THE YEAR AS A WHOLE WILL BE ABOUT 60 PERCENT LESS THAN THAT RECORDED IN 1974. DURING THE FIRST EIGHT MONTHS OF THE YEAR, THE CURRENT ACCOUNT WAS IN DEFICIT BY 994 MILLION POUNDS COMPARED TO 2,306 MILLION POUNDS DURING THE SAME PERIOD IN 1974.

15. THE AREA OF MOST NOTICEABLE IMPROVEMENT IS IN TRADE IN GOODS OTHER THAN PETROLEUM PRODUCTS. DURING THE FIRST EIGHT MONTHS OF 1975, THERE WAS A SURPLUS OF 24 MILLION POUNDS IN TRADE OTHER THAN PETROLEUM PRODUCTS COMPARED TO A 1,136 MILLION POUND DEFICIT RECORDED IN THE FIRST EIGHT MONTHS OF 1974. IN THE FIRST HALF OF THE YEAR, EXPORT VOLUME GREW RELATIVE TO IMPORTS, WHILE THE VALUE OF EXPORTS GREW AT A MUCH MORE RAPID RATE, THEREBY PRODUCING A
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FAVORABLE TERMS OF TRADE EFFECT. FUNDAMENTALLY, IMPORTS WERE DOWN DUE TO THE REDUCED LEVEL OF CONSUMER EXPENDITURE AND THE RAPID RATE OF INVENTORY DESTOCKING. IT IS NOT ANTICIPATED THAT INVENTORIES WILL BE REBUILT UNTIL SUCH TIME AS THERE ARE POSITIVE SIGNS OF AN UPTURN IN DOMESTIC CONSUMPTION. THIS LOW LEVEL OF CONSUMER DEMAND COUPLED WITH AN EXPECTED UPTURN IN WORLD TRADE SHOULD CONTINUE TO AID THE CURRENT ACCOUNT POSITION THROUGHOUT THE REMAINDER OF THE YEAR AS WELL AS IN THE FIRST HALF OF 1976. HM TREASURY STAFF EXPECTATIONS ARE THAT WORLD TRADE WILL SHOW AN ANNUAL RATE OF INCREASE OF 15 PERCENT PER QUARTER DURING 1976, WITH UK EXPORT VOLUME INCREASING BY ABOUT 9 PERCENT PER QUARTER (AGAIN, QUARTERLY INCREASES AT ANNUAL RATES).

16. THE IMPORT OF PETROLEUM PRODUCTS HAS ALSO BEEN AT A REDUCED RATE DURING 1975 COMPARED TO 1974, ALTHOUGH THE IMPROVEMENT IN THIS SEGMENT OF THE VISIBLE TRADE ACCOUNT HAS BEEN LESS SIGNIFICANT THAN IN THE NON-PETROLEUM SEGMENT. THE NET BALANCE ON TRADE IN PETROLEUM PRODUCTS SHOWED A DEFICIT OF 1,934 MILLION POUNDS IN THE FIRST EIGHT MONTHS OF 1975 COMPARED TO 2,244 MILLION POUNDS DURING THE COMPARABLE PERIOD IN 1974. THERE WAS, HOWEVER,

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CONSIDERABLE DESTOCKING OF PETROLEUM RESERVES DURING THE FIRST HALF OF THE YEAR, AND INDICATIONS ARE THAT THESE STOCKS HAVE BEEN REBUILT DURING THE THIRD QUARTER IN ANTICIPATION OF THE HIGHER OPEC PRICE AND APPROACHING WINTER MONTHS. INDUSTRIAL DEMAND REMAINS LOW AND A MAJOR RESURGENCE SEEMS UNLIKELY OVER THE NEXT TWELVE MONTHS. AS NOTED, THERE WAS A SURGE IN PETROLEUM IMPORTS IN JULY AND AUGUST, AND IT IS ANTICIPATED THAT THE FIGURES FOR SEPTEMBER AND OCTOBER WILL LIKEWISE BE HIGHER THAN THOSE WITNESSED DURING THE FIRST HALF OF THE YEAR. THE IMPORT VOLUME IS EXPECTED TO RETURN TO THE EARLY 1975 LEVELS BY THE END OF THE YEAR.

17. THERE WERE SEVERAL "SPECIAL" FACTORS DURING JULY AND AUGUST WHICH ADVERSELY AFFECTED THE CURRENT ACCOUNT POSITION. THERE WERE IMPORTS OF THREE NORTH SEA OIL RIGS WHICH ADDED NEARLY 200 MILLION POUNDS TO THE IMPORT BILL AND ANOTHER 50 TO 80 MILLION POUNDS SHOULD SHOW UP IN THE SEPTEMBER FIGURES. AS NOTED, PETROLEUM RESERVES WERE DRAWN DOWN DURING THE EARLY MONTHS
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OF THE YEAR AND THERE IS EVIDENCE THAT THERE WAS A "RUSH" TO REPLENISH THESE STOCKS BEFORE THE OPEC PRICE INCREASE. TOO, THERE WILL BEGIN TO BE A REDUCTION IN IMPORTS RELATED TO NORTH SEA OIL DEVELOPMENT WHICH ARE CURRENTLY ADDING 500-600 MILLION POUNDS PER YEAR TO THE DEFICIT.

18. FOR THE YEAR 1975 AS A WHOLE, WE ANTICIPATE THAT THE CURRENT ACCOUNT WILL BE IN DEFICIT BY 1,200 TO 1,400 MILLION POUNDS COMPOSED OF A VISIBLE TRADE DEFICIT OF 2,600 TO 2,800 MILLION POUNDS, AND A SURPLUS ON INVISIBLE TRANSACTIONS OF ABOUT 1,400 MILLION POUNDS. FOR 1976, WE DO NOT ENVISAGE A SUBSTANTIAL IMPROVEMENT OVER 1975 ALTHOUGH SOME BUT NOT ALL UK OFFICIALS BELIEVE THAT WORLD CYCLICAL FACTORS WILL FAVOR THE UK AND LEAD TO AS MUCH AS A 50 PERCENT IMPROVEMENT YEAR-ON-YEAR. HOWEVER, THE INCREASE IN PETROLEUM PRICES WILL ADD AN ADDITIONAL 300 MILLION POUNDS TO THE IMPORT BILL AND THE CONTINUED DEVALUATION OF STERLING WILL INCREASE THE COST OF NEEDED RAW MATERIALS ONCE THE ECONOMY TAKES AN UPTURN. SINCE EFFECTS OF STERLING DEVALUATION ARE MORE RAPIDLY REFLECTED IN IMPORT PRICES THAN IN AN INCREASED DEMAND FOR EXPORTS, WE SEE

ONLY LIMITED SCOPE FOR IMPROVEMENT OVER THE NEXT TWELVE MONTHS. BEYOND THAT POINT, THERE IS REASON TO HOPE FOR IMPROVEMENT BASED ON (A) INCREASED EXPORT GROWTH IN RELATION TO IMPORTS AS WORLD TRADE PICKS UP WITH THE UK'S OWN DOMESTIC RECOVERY LAGGING IN THE CYCLE, AND (B) THE GRADUAL COMING ON STREAM OF NORTH SEA OIL, WITH LESSENER IMPORTS FOR ITS DEVELOPMENT AND AN INCREASE IN FLOW OF THE OIL ITSELF REDUCING THE NEED FOR PETROLEUM IMPORTS; THIS TREND IS CONSISTENT WITH INTERNAL HMG AND PRIVATE SECTOR FORECASTS AND WE ARE IN AGREEMENT WITH THEM (SEE LONDON A-528)

19. GIVEN CONTINUING DIFFERENTIAL RATES OF INFLATION, ANY PRUDENT FORECAST MUST MAKE PROVISION FOR A FURTHER DECLINE IN STERLING'S TRADE WEIGHTED DEVALUATION FROM ITS CURRENT LEVEL OF ABOUT 29 PERCENT TO ABOUT 35 PERCENT BY THE END OF 1976, SAY ROUGHLY 1 - 1.5 PERCENT PER QUARTER.

FORECASTS

20. THE GOVERNMENT'S OWN PUBLISHED FORECAST OF THE LIKELY OUTCOME FOR THE YEAR SET FORTH IN THE APRIL BUDGET HAS CONFIDENTIAL

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BEEN OVERTAKEN BY EVENTS. HOWEVER, SENIOR OFFICIAL IN HM TREASURY HAS SUPPLIED FINANCIAL ATTACHE ON PERSONAL AND CONFIDENTIAL BASIS -- NOT IN ANY CASE TO BE MADE PUBLIC -- OF LATEST INTERNAL FORECAST, COMPLETED ROUGHLY TWO MONTHS AGO. IT IS IN PROCESS OF BEING REVISED. WE THINK IT IS TOO OPTIMISTIC IN TERMS OF GDP PERFORMANCE, AND UNEMPLOYMENT TRENDS (WHICH ARE SUPPLIED ON DIFFERENT BASIS FROM OTHER FORECASTS WHICH FOLLOW AND TOO PESSIMISTIC IN BALANCE OF PAYMENTS. UNLESS NOTED, FIGURES ARE ON BASIS OF PERCENTAGE CHANGE OVER PREVIOUS YEAR.

	1975	1576
A. REAL GDP	-0.3	PLUS 2.0
(ANNUAL PERCENT CHANGE)		
B. INDUSTRIAL PRODUCTION	-6	PLUS 5
(ANNUAL PERCENT CHANGE)		
C. MANUFACTURING INVESTMENT	-12	-10
(ANNUAL PERCENT CHANGE)		
D. RETAIL PRICES	24	13
(ANNUAL PERCENT CHANGE)		
E. UNEMPLOYMENT		
(AVERAGE NUMBER IN MILLIONS)	0.930	OVER 1
(PERCENT)	4.0	OVER 4.3

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ACTION EUR-12

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SP-02 AID-05 EB-07 NSC-05 CIEP-01 TRSE-00 SS-15

STR-04 OMB-01 CEA-01 CIAE-00 COME-00 FRB-03 INR-07

NSAE-00 XMB-02 OPIC-03 LAB-04 SIL-01 L-03 H-02 PA-01

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F. BALANCE OF PAYMENTS

(BILLIONS OF POUNDS)

CURRENT ACCOUNT	-1.7	-2.0
VISIBLE TRADE	-3.2	-3.5
INVISIBLES	1.5	1.5

21. THE MAJOR PRIVATE FORECASTERS, INCLUDING THE NATIONAL INSTITUTE (SEE LONDON 13445) AND THE LONDON BUSINESS SCHOOL (SEE LONDON A-745) AND INVESTMENT AND BROKERAGE HOUSES SBOW THE FOLLOWING RANGE OF OUTCOME FOR 1975 AND 1976 (WITH 1974 SHOWN FOR REFERENCE).

	1974	1975	1976
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A. REAL GDP

(ANNUAL PERCENT CHANGE) -0.7 -1.0 TO 0.6 -0.2 TO 1.4

B. INDUSTRIAL PRODUCTION

(ANNUAL PERCENT CHANGE) -3.1 -4.1 TO -4.3 -0.4 TO 0.8

C. MANUFACTURING INVESTMENT

(ANNUAL PERCENT CHANGE) 10.9 -11.3 TO -13.1 -6.7 TO -14.0

D. RETAIL PRICES

(ANNUAL PERCENT CHANGE) 16.1 21.0 TO 24.7 14.0 TO 16.4

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E. UNEMPLOYMENT (DEC.)

(NUMBER IN MILLIONS,S.A.) 0.644 1.080 1.25 TO 1.4

(PERCENT) 2.8 4.8 6.1 TO 6.8

F. CURRENT ACCOUNT

(BILLIONS OF POUNDS) -3.8 -0.7 TO -1.5 -1.4 TO 0.6

22. AT LEAST ONE UNION (SCIENTIFIC, TECHNICAL AND MANAGERIAL STAFFS) IS PREDICTING UNEMPLOYMENT UP TO 1.9 MILLION BY JULY 1976, WITH INDUSTRIAL OUTPUT CONTINUING TO FALL UNTIL LATE SPRING, AND AN INCREASE IN THE CURRENT ACCOUNT DEFICIT, TO 2.2 BILLION POUNDS.

OUR ASSESSMENT OF DEVELOPMENTS

24. OUR CRITICAL ASSESSMENT OF SPECIFIC TRENDS AND DEVELOPMENTS LIKELY TO AFFECT THE SHORT-TERM OUTLOOK ARE GIVEN IN THE TEXTUAL COMMENTARY IN THE FIRST THREE SECTIONS. OUR OWN BEST QUANTITATIVE ESTIMATE OF THE LIKELY OUTCOME THIS YEAR AND NEXT IS AS FOLLOWS:

1974 1975 1976

A. REAL GDP (OUTPUT)

(ANNUAL PERCENT CHANGE) 0.7 -1.8 TO -2.8 1.5 TO 2.5

B. INDUSTRIAL PRODUCTION

(ANNUAL PERCENT CHANGE) -3.1 -4 TO -5 4 TO 5

C. MANUFACTURING INVESTMENT

(ANNUAL PRECENT CHANGE) 10.9 -10 TO -15 -10 TO -12

D. RETAIL PRICES

(ANNUAL PERCENT CHANGE) 16.1 23 TO 25 14 TO 16

E. UNEMPLOYMENT (DEC.S.A.)

(NUMBER IN MILLIONS) 0.644 1.1 TO 1.2 1.3 TO 1.4

(PERCENT) 2.8 4.5 TO 5.2 5.6 TO 6.1

F. CURRENT ACCOUNT

(BILLIONS OF POUNDS) -3.8 -1.2 TO -1.4 -1.2 TO -1.4

25. GDP WILL STOP FALLING IN THE SECOND HALF OF 1975; RECOVERY BEGINNING IN THE FIRST HALF OF NEXT YEAR. INDUSTRIAL PRODUCTION WILL FOLLOW A SIMILAR PATTERN. MANUFACTURING INVESTMENT IS NOT LIKELY TO RECOVER UNTIL THE SECOND HALF OF NEXT YEAR. THE TREND IN RETAIL PRICES NEXT YEAR AT ANNUAL RATES IS LIKELY TO BE IN RANGE OF

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ACTION EUR-12

INFO OCT-01 ISO-00 EURE-00 SSO-00 NSCE-00 USIE-00 INRE-00

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22; 18; 14; SLIPPING TO 12 PERCENT IN THE FOURTH QUARTER. INCOMES POLICY WILL BE CONTINUED BUT IN MODIFIED FORM. UNEMPLOYMENT WILL CONTINUE TO RISE UNTIL MID-1976, THEN BEGIN TO DECLINE SLOWLY. BALANCE OF PAYMENTS DEFICIT ON CURRENT ACCOUNT WILL BE ROUGHLY DIVIDED THROUGHOUT 1976, WITH AN INCREASE IN IMPORTS IN THE SECOND HALF OF THE YEAR ASSOCIATED WITH RECOVERY, BEING OFFSET IN PART BY NORTH SEA OIL DELIVERIES. THE GOVERNMENT HOPES THAT IF IT CAN SHOW PROGRESS IN CHANGING THE DIRECTION OF THE UNDERLYING TRENDS, CONFIDENCE OF INTERNATIONAL INVESTORS IN STERLING WILL BE MAINTAINED.

26. LOOKING FORTHER AHEAD, THE SOLUTION TO THE UK'S ECONOMIC PROBLEMS CANNOT BE SOLVED BY SHORT TERM POLICIES. ON THE HOPEFUL SIDE, THERE DOES SEEM TO BE GENERAL SUPPORT FOR THE GOVERNMENT'S PROGRAM TO HALT INFLATION. THE BANK OF ENGLAND, THE NATIONAL ECONOMIC DEVELOPMENT OFFICE, AND THE CBI ARE DOING THEIR BEST TO POINT OUT THE NOXIOUS EFFECTS THAT THE SECULAR DECLINE IN PROFITS HAS HAD ON INVESTMENT. THE TREASURY IS STRENGTHENING ITS ROLE IN IN-
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DUSTRIAL POLICY FORMULATION, ATTEMPTING TO PUSH GOVERNMENTAL ASSISTANCE TO THOSE FIRMS THAT STAND THE BEST CHANCE OF COMPETING INTERNATIONALLY. BUT THESE ARE MEDIUM TERM OBJECTIVES, AND THE DEGREE OF THEIR ACHIEVEMENT WILL DEPEND ON BASIC ATTITUDES THAT TRANSCEND ECONOMIC POLICY. LONGER TERM BUSINESS CONFIDENCE IN THE SYSTEM IS CRUCIAL.

27. THE DESIRABLE DEGREE OF STATE CONTROL AND OWNERSHIP OF INDUSTRY IS SOMETHING THAT THE BRITISH HAVE TO WORK OUT FOR THEMSELVES. AT THIS WEEK'S LABOUR PARTY CONFERENCE, ENERGY MINISTER TONY BENN QUOTED LABOUR PARTY DOCTRINE OF FORTY YEARS AGO TO THE EFFECT THAT THE EVILS OF CAPITALISM ARE CAUSED BY PRIVATE OWNERSHIP OF THE MEANS OF LIFE, AND THE REMEDY IS PUBLIC OWNERSHIP; HIS SPEECH RECEIVED A STANDING OVATION. THIS SORT OF RHETORIC DOES NOT HELP BUILD BUSINESS CONFIDENCE. IN CONTRAST, THE CHANCELLOR'S BASIC AIMS ARE CORRECT, BUT UNTIL THE UK CAN FIND A MEANS OF INCREASING INVESTMENT AND PRODUCTIVITY IN MANUFACTURING INDUSTRY, IT IS UNLIKELY THAT THE UK WILL PERFORM AT ANYTHING LIKE ITS FULL POTENTIAL.

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